# THE FINANCIAL STRUCTURE OPTIMIZATION - A STRATEGIC TOOL FOR COMPETITIVE FIGHT OF COMPANIES

[a]ANNA JACKOVÁ

*University of Žilina, Faculty of Management Science and Informatics, Univerzitná 8215/1, 101 26 Žilina, Slovak republic, email: [a] Anna.Jackova@pd.uniza.sk*

Abstract: The financial structure optimization is one of the strategic tools for competitive fight of companies. Decision making on the financial structure is an extremely important and key task of financial management of each company. Financial theory and practice do not give a generally respected recommendation for the composition of the company's financial resources. All companies are unique systems with distinctive features. They vary, for example, by asset structure, development phase, investment, and various market positions. There is also a different need for capital with which the company operates. Therefore, it is important for managers to make right decisions, to consider all the risks and uncertainties, and to respect the individual conditions of each company.

Keywords: financial structure, capital structure, financial analysis, optimization.

## 1 Introduction

All business decisions will be ultimately reflected in some of the company's financial results. That is the reason why financial managers are trying to make decisions that increase the performance and efficiency of the company.

The most discussed and most often addressed issues of company management are questions relating to the financial structure and decision-making about its optimization. The financial structure and capital that company uses to finance its activities are topics that are currently highly up-to-date, and this topic is becoming increasingly important and even more crucial in the company's financial management. This is mainly because the financial structure and its optimal state are largely involved in achieving the financial stability and prosperity of the company and thus the overall efficiency of the company.

Decision-making on funding sources represents an important part in the financial management process, which, on the other hand, is very demanding. The necessity of making the right decision requires the respect of a quantitatively large number of factors that determine the financial structure of the company. In addition, this is a controversial area where there is a contradiction in a number of expert opinions. The subject of an argument is whether the optimal financial structure of the company exists at all and, if so, on what criteria it can be defined. That is why it is hard for the company and especially the financial manager to decide on the optimal ratio of own and foreign capital, in which capital costs will be minimal and at the same time the market value of the company will be at the maximum.

## 2 Financial and capital structure of a company

Financial management of the company, when deciding on a long-term financial plan, decides on the structure of sources of capital needs. "We understand the financial structure of a company as a share of individual components of own and foreign capital in the total capital that financially covers the assets of a company. The liabilities side of company's balance sheet characterizes the static state of the financial structure. The dynamics of the process expresses the share of own and foreign capital in the financial coverage of the increase of the company assets for a certain period.

Both capital and financial structures can be viewed from a static or dynamic perspective. Both aspects are related. The structure of resources that finance the growth of company assets in individual period changes their overall structure at given individual moments (the date of the balance sheet). Due to dynamic changes, the static situation changes" (Vlachynský et al, 2006, p. 83).

The financial structure can be understood in the broad sense as the structure of the total capital that finances the assets of a company. It follows the part of the capital structure is a part within the company's financial structure. The capital structure expresses the way in which a company finances its overall operations and growth through a variety of funding sources. Debt comes in the form of different types of loans that have to be paid in the future, usually with some kind of interest. Equity includes, in addition to retained earnings, the sale of the company's share to investors in the form of equity and preferred shares. Investors thus become business owners and partners, thereby gaining a certain degree of control over the company and return on their investments.

There is a number of factors affecting the financial structure of the company. It may be the cost of acquiring and linking the various components of capital, the risks associated with the disproportionately increasing credit load, the composition of the company's assets. In addition, it can be sudden changes and prospects of cash flow development, the way and the strength of the company's income taxation, the necessity of adhering to the selected level of liquidity and other. The company's financial structure is also affected by the ability to sell its products and services. In the broader context, it is also all employees who affect the composition of costs and revenues by adding their work and their abilities to the value of corporate performance. Consequently, the overall trading income, which affects largely the financial structure of a company.

## 3 Composition of company financial structure

The financial structure is a composition that according to the accounting consists of the liabilities side of company‘s balance sheet. It consists of equity, liabilities and a time distinction.

### 3.1 Equity

Equity represents the accounting unit‘s own sources of cover and is an indicator of the financial stability of the company. Equity is identical to the net trading value provided by the Commercial Code. At the same time, it defines its individual elements, to which belongs:

- basic capital,
- emission premium,
- other capital funds,
- statutory reserves,
- other funds from profits,
- valuation differences from revaluation,
- trading income of previous years,
- trading income for the period after tax.

Basic capital represents the resources that the founders and investors put into business in the monetary as well as in the non-monetary form and the company formed it or reduced itself. The obligation to create capital also applies to companies with a legal form of Joint Stock Company, a Limited liability company and a simple company for shares, which also derives a fixed minimum capital. In the joint stock company it is 25 000, - €, in the limited company it is 5 000, - € and in the simple company for shares it is 1, - €.

The emission premium represents the difference between the nominal value of the shares issued and the amount paid for shares (Emission rate) under a special regulation or deposits in the increase of the basic capital by subscription of new shares or deposits.

Other capital funds are monetary and non-monetary deposits that are intended to increase equity (but not to the basic capital, nor are they incurred as an emission premium). They can be received gifts, i.e. tangible and non-tangible assets acquired free of charge, money gifts and member shares for cooperative housing construction and state contribution in cooperatives.

Statutory reserve funds are compulsorily generated from the earnings of company unit. "Since the creation of a fund is mandatory, the law specifies exactly how it is created, as well as its minimum amount. From the point of view of the law, this refers to the statutory reserve fund or the indivisible fund of the cooperative" (Šiman, Petera, 2010, p. 60).

The company creates other funds from profit based on an optional decision. The statutory body decides to create a statutory fund, as the possible alternative to the other funds from profit. Financial sources from this fund will be used up, for example, in the form of rewards attributable to members of the statutory body.

Valuation differences from revaluation are valuation differences from property and liability revaluation, valuation differences from equity investments and revaluation differences when merging, fusing and disposing of a company.

The trading income of previous years is the profit or loss that a company has obtained for the immediately preceding accounting period. In addition, an accounting unit has the obligation to use the trading income, therefore to keep it books until it is decided on what specific purpose it will applied (payment of the loss, reduction / increase of the basic capital, allocation to the basic reserve fund and others).

The trading income for the post-tax period can also be defined as the official residual shown on line no. 61 of the Profit and Loss Statement. It follows that the trading income represents the difference between the accounting revenue and the accounting cost, which may be positive (profit) or negative (loss). It should be noted that the trading income in the profit and loss statement must be consistent with the trading income shown on line no. 100 in the balance sheet.

**3.2 Liabilities**

Liabilities represent the financial liabilities and debts of the accounting unit that arise from past transactions in the course of business operations. The accounting unit pays these financial liabilities to external stakeholders through the transfer of economic benefits that involve cash, goods or services. Interested parties include banks or other financial institutions, creditors or state institutions. Liabilities include reserves, liabilities, bank loans and short-term financial assistance.

Reserves belong to a group of liabilities that are uncertain in terms of time and amount, but on the other hand, their intended purpose is known in advance. The obligation to make reserves in the company is a matter of law and of the agreements and contracts concluded. The company creates reserves for future expenses that may arise against suppliers, employees, members of the Supervisory Board, other business bodies, and so on. The company's liabilities can also be classified as a debt that the company is required to pay. From a time perspective, the liabilities consist of long-term liabilities that the company pays for a period of one year and short-term liabilities with a maturity up to one year or a normal business cycle, whichever is longer.

Bank loans are a temporary loan provided by a commercial bank to a client who is obliged to return to the bank not only the provided financial support but also to repay it by paying a certain amount of interest. This subsidy relationship may be of a long-term, medium-term or short-term nature, for securing it, eligible loans, advances or personal or material guarantees are acceptable. Short-term financial assistance consists of funds borrowed and managed by the company, but unlike bank loans, the provider of the assistance is a business unit other than a commercial bank, or the short-term financial assistance was created by issuing mortgage bonds or issuing short-term bonds.

**3.3 The time distinction**

In accordance with the applicable provisions of The Accounting law, the cost and revenue time distinction is intended to overcome time discrepancies that arise in relation to costs and expenses or revenues and returns. Therefore, in terms of liabilities, it is said about:

- long-term deferred expenses,
- short-term deferred expenses,
- long-term, future returns,
- short-term future returns.

"Within deferred expenses, which include both short-term and long-term expenses, it is a time distinction of the current accounting period costs related to expenses in certain future periods, such as lease payments payed behind. Settlement of deferred expenses is charged when the expense is incurred, e.g. rent paid behind, interest on loans paid behind" (Štangová, Hajduchová, 2010, p. 126).

"Both short-term and long-term future returns can be characterized as income in the current accounting period that is intrinsically included in returns in future periods, such as rentals received in advance, amounts paid in advance to provide service and received subscriptions. Settlement of future returns is made in the period with which accrued return is materially related, for example, Rents received in advance, pre-paid subscriptions, royalties received in advance" (Štangová, Hajduchová, 2010, p. 133).

**4 Factors affecting the financial structure of a company**

The formation of a company's financial structure takes into account factors, which at first glance create the impression of opposites. The factors required and taken into account in this case include:

- the cost of capital,
- formation of insolvency,
- composition of company assets,
- level and fluctuations of cash flow,
- effect of inflation,
- the rate and intensity of corporate income taxation,
- financial freedom of a company.

**4.1 The cost of capital**

The cost of capital represent the cost of financial resources used to finance business activities. The cost of capital is associated with the different types of capital that a company uses. Each type of capital, that is, each component of total capital has its own price, which is based on the rate of return required by the investors who provided the financial resources to the company. The costs of own and foreign capital and average costs of total capital are distinguished. "In the case of foreign capital it is interest. In the case of equity, it is the net profit expected by the owners of the company for their capital deposit" (Ďurišová, Jacková, 2015, p. 44).

**4.2 Formation of insolvency**

"Insolvency is in bankruptcy proceedings identified as one of the material conditions for declaring bankruptcy. Insolvency is defined as a form of bankruptcy, which is the reason and condition for declaring bankruptcy" (Ďurica, 2010, p. 131). If a company continuously increases the ratio of foreign capital to total capital, the risk of insolvency is only a matter of time. This is because the debt service, regardless of the positive or negative trading income achieved, must be constantly secured. In this case, even a slight fluctuation in the company's revenues and costs may cause insolvency to pay interest or repayments. Ultimately, this situation may culminate in bankruptcy as one of the possible solutions to the crisis the company has fallen into.

**4.3 Composition of company assets**

"Company assets represent the sum of all items, money, receivables and other property values that belong to entrepreneurs and serve to carry out business activities. It consists of two basic groups of resources, which differ in the time it takes to operate the business before returning to the cash form. We talk about long-term assets, current assets and temporary assets captured by the left-hand side of the balance sheet. They are also referred to as assets" (Synek et al, 2011, p. 48). From the point of view of the financial structure, the structure of corporate assets plays an important role, especially from the point of view of asset quality and liquidity. The basis for this argument is the fact that the liquidity of assets determines to a significant extent the composition of the company's financial resources.

**4.4 Level and fluctuation of cash flow**

The company's prospects to meet its debt obligations in the future are heavily influenced by both the level and the fluctuations in the cash flow. It is true that if a company expects an overall increase in its sales without limiting greater fluctuations, the share of foreign capital in this case does not play an important role. The cash flow that a company expects to achieve represents a sufficient guarantee accepted by creditors. To increase the share of foreign capital, a company should not enter into a period when it expects that the development of its boom in revenue and profit would be interrupted. In this situation, it should be just a matter of reducing the share of foreign capital, which should be sought primarily by company for the sake of its protection and stability.

**4.5 The rate and intensity of corporate income taxation**

The rate and the intensity by which the positive trading income of a company is taxed represents the substantial part in forming the financial structure. The justification for this is that interest paid out of foreign capital is part of the cost, which reduces corporate profits and therefore the tax base on income tax. The rate and intensity of taxation is more pronounced on the financial structure when the tax rate rises up and is substantially higher.

**4.6 Financial freedom of a company**

"Financial freedom means choosing a capital structure so that the company can secure the fast availability of money to take advantage of a good investment opportunity or other market chances. A higher share of own capital enables greater flexibility in decision-making" (Sedlák et al, 2007, p. 221). Financial freedom is an advantage especially for companies that have a great potential for developing their activities. A more conservative financial structure in the form of an increased share of own capital enables such companies to prevent any intervention by creditors into the business.

**5 The role of financial analysis**

The answer to the question of whether to self-finance the business or to fund the use of foreign resources gives a financial analysis.

Financial analysis is an inseparable part of a company's financial management that provides sufficient feedback on the areas in which the company stands out and vice versa, where the company has certain absences. Financial analysis eliminates ignorance and contributes to a perfect knowledge of the financial situation of the company.

There is multiple of financial analysis methods. Among the basic belong analysis of absolute indicators, which consists of the horizontal and vertical analysis. Horizontal analysis, also known as trend analysis, compares financial information over a series of accounting periods, while vertical analysis is directly proportional to the analysis of the financial statements, where each line indicates a percentage from another item. In practice, this means that individual items in the profit and loss statement are quantified as a percentage of total costs or revenues. In the case of a balance sheet, the individual items are quantified either as a proportion of the total assets or the sources of their coverage, i.e. at this point it means the asset and capital structure of the company. Using the absolute indicators, some other difference indicators can also be calculated, for example, the golden balance rule and net working capital.

The next method of financial analysis, which can also be described as the basic tool for determining performance and stability, is financial ratios, including profitability, liquidity, activity, productivity, indebtedness and capital market. In contrast to the analysis of the set of indicators, as one of the methods of financial analysis, it includes pyramid decompositions, credit and bankruptcy models. Banknote indicators are primarily intended for creditors who focus their attention on the ability of a company to meet its obligations to them. Creditworthy indicators reflect the positive side of a company, which is based on its performance quality, which is particularly beneficial to investors and publishers.

The optimization of the financial structure assessed on the basis of the financial analysis will ultimately be reflected not only in the financial management of the company but also in its relations with employees (work/wage), suppliers, buyers (goods/payment), banks (loan/interest) Business owner (deposit/return).

**6 Optimization of financial structure**

The financial structure of a company influences a number of factors that need to be taken into consideration when optimizing it. From the point of view of the source from which the individual factors flow, it is possible to categorize them as internal and external. Internal factors represent a category of specific factors that are exclusively related to the business being optimized and its financial structure. In contrast, on the one hand, external factors group factors of a universal nature that affect any company without exception, and on the other hand factors that determine the specific aspects of the Slovak economy.

Factors affecting the financial structure of a company:

1. Internal factors:
- the asset structure of a company with a significant proportion of current assets,
- the size and stability of profit of long-term company in the market,
- choice of financial structure in the future,
- company liquidity and lack of cash flow,
- company strategy in the area of goals,
- managers' approach to managing and financing of the company.

2. External factors:
- interest rate development when drawing foreign sources,
- developments in the financial market situation,
- legal form of business,
- tax determinants and overall tax burden on the company,
- favorable macroeconomic situation of the SR,
- attractiveness of the national economy sector.

By identifying internal and external factors, it is possible to proceed with the proposal to optimize the financial structure. However, in addition to the factors, the proposal must take into account a number of additional knowledge that is specified in the various phases of the proposal.

The proposal for optimizing the financial structure of a company consists of three stages:

- testing of the financial structure in terms of compliance with the basic funding rules,
- testing of determinants affecting the financial situation,
- applying suggested recommendations.

The goal of first phase is the basic orientation in consideration of the rationality of the company's financial structure; the criterion is the golden rule of financing and used the vertical and horizontal analysis of the company balance sheet.

The second phase aims at long-term financial stability, solvency and stabilization of the company's trading income. The criterion is a set of selected financial analysis indicators and planned profit. The ex-post and ex ante financial analyses are performed.

The third phase goals is the optimal financial structure, the criterion is profitability of own capital and method of optimization.

The proposed optimization of the company's financial structure monitors the company's prosperity and progress, meeting its main goals, increasing its profitability and its market share.

**7 Conclusion**

The financial structure, as well as its optimization, has been the subject of a number of considerations. While theoretical financial discipline excludes the presence of an optimal financial structure, the practice creates situations in which the attention paid to the financial structure is greatly underestimated. Companies often try to get financial resources because of financial difficulties, not even considering optimizing them. On the other hand, relatively profitable companies also omit this area of their financial management. The optimal financial structure should have its irreplaceable representation in the significant features that describes the company.

**Literature:**

1. Ďurica, M.: *Konkurzné právo na Slovensku a v Európskej únií.* Bratislava: EUROKODEX, 2010. 816 p. ISBN 80-8944-731-7.
2. Ďurišová, M., Jacková, A.: *Podnikové financie*. Žilina: EDIS, 2015. 187 p. ISBN 978-80-554-1006-7.
3. Sedlák, M. et al.: *Podnikové hospodárstvo*. Bratislava: Wolters Kluwer, 2007. 255 p. ISBN 978-80-8078-093-7.
4. Synek, M, et al.: *Manažérska ekonomika.* Praha: Grada Publishing, 2011. 471 p. ISBN 80-2473-494-X.
5. Šiman, J., Petera, P.: *Financovaní podnikatelských subjektů. Teorie pro praxi*. Praha: C. H. Beck, 2010. 192 p. ISBN 80-7400-117-2.
6. Štangová, N., Hajduchová, E.: *Účtovníctvo.* Bratislava: crr.sk, 2010. 198 p. ISBN 978-80-970495-5-3.
7. Vlachynský, K. et al. *Podnikové financie*. Bratislava: Ekonómia, 2006. 482 p. ISBN 80-8078-029-3.

**Primary Paper Section:** A

**Secondary Paper Section:** H